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ABSTRACT

This is a teacher's guide to a 20-minute color videocassette program that teaches high school students about the history of the U.S. monetary system and events leading to the establishment of the Federal Reserve System. The video program portrays episodes in U.S. history when the country was faced with problems of too much or too little money. These episodes include the Colonial and Revolutionary War periods, the years of the two Banks of the United States, the Civil War period, and the Greenback and Populist eras. Several conventions and institutions devised to solve money problems are highlighted. Among these is the Federal Reserve System, created by Congress in 1913 and given the responsibility of promoting a healthy economy through the control of the banking system's ability to create money. The teacher's guide outlines student objectives, provides a program synopsis, and presents discussion questions. Historical notes are provided concerning the colonies, the first bank, the second bank, the antebellum period, the Civil War, the post-Civil war era, the Federal Reserve System, and Gresham's Law. The guide concludes with a bibliography of free materials available from the Federal Reserve System. (RM)

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A Teacher's Guide to

Too Much, Too Little

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TOO MUCH, TOO LITTLE

A Teacher's Guide

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CONCEPT

The problem of providing the "right" amount of money for the economy has roots older than the nation itself. The Federal Reserve System, created by Congress in 1913, evolved from political and economic attempts throughout America's history to address this problem.

STUDENT OBJECTIVES

After viewing the video program, students will be able to:

- name at least three events in American history that influenced Congress to create the Federal Reserve System and empower it to try to control the supply of money in the United States;
- identify the Federal Reserve System as the institution responsible for providing the "right" amount of money for a healthy and growing economy;
- explain that money is only one of several factors influencing our economy;
- cite at least one advantage of the political independence of the Federal Reserve System; and
- describe one way in which the Federal Reserve System's goals to promote economic stability might affect them or their families.

PROGRAM SYNOPSIS

Centering on a simple transaction involving two high school students and the sale of a car, the video traces the historical development of banking, and money and its management. Throughout history, the United States has struggled with a variety of institutional arrangements to obtain the "right" amount of money. Too much money, or even too little, can have a significant effect on the functioning and health of our economic system.

The video portrays episodes in American history when the country was faced with problems of too much or too little money. These episodes include the Colonial and Revolutionary War periods, the years of the two Banks of the United States, the Civil War period, and the Greenback and Populist eras.

Several conventions and institutions devised to solve problems posed by too much or too little money and by the instability in the U.S. economy are highlighted: Colonial paper money issues, the Continental Congress, the First and Second Banks of the United States, the free banking era, the national bank system, the gold and silver standard debates, and the Panic of '07 and the creation of the Federal Reserve System.

The Federal Reserve System is presented as the agency created by Congress and given the responsibility of promoting a healthy economy through the control of the banking system's ability to "create money." This power over money creation is, however, only one factor affecting the economic well-being of the American people.

POST VIEWING QUESTIONS

Students should be able to answer satisfactorily the following questions after having seen the video.

1) In the Colonial era, how did the amount of paper notes issued affect the level of prices?
2) Why did the British restrict the Colonies' issuance of money? What was the result of this restriction?
3) In the early years of our history, in what form did banks make loans to customers? Today, how do banks make loans to their customers?
4) Does a currency's backing by gold or silver give money its value? When specie redemption was suspended, what gave paper money its value?
5) Why did the protest movements of the 1870s and 1890s focus on the institutional arrangements which determined the money supply?
6) What is a financial panic?
7) What was the impetus for the establishment of the Federal Reserve System?
8) What is a central bank and how does it affect the behavior of private banks?
9) In addition to the Federal Reserve, what are some of the other factors that affect our economic system?
10) Why is it desirable to have a politically independent central bank?

QUESTIONS FOR FURTHER STUDY

Answers to the following questions are based on the material contained in this Teacher's Guide.

1) What were the components of the money supply in Colonial times? Today?
2) What were some of the problems with using commodity money in Colonial America?
3) How did the Continental Congress finance its spending programs? What was the economic effect of its financing arrangements?

4) What is a bimetallic standard? How does Gresham's Law describe what often happens to such a standard?

5) Why did Hamilton support the establishment of the First Bank of the United States? Why did Jefferson oppose it?

6) How did the First Bank of the United States differ from banks which existed at the time?

7) Why did a central bank become necessary as the U.S. economy developed?

8) Without the First Bank of the United States, how was the War of 1812 financed? What was the economic result of the federal government's financing arrangement?

9) What are "pet" banks? How did they come about?

10) What is "free banking"? What is "wildcat banking"? Are the two related?

11) Why did the national bank system come into existence? Why did the federal government impose a tax on the paper note issues of state-chartered banks during the Civil War? What was the effect of that tax?

12) What were the monetary planks of the Greenback Party and the Populist Party platforms?

13) What were the major changes which occurred in our monetary and banking system between 1862 and 1913?

14) What did Congress do in response to the Panic of 1907?

15) The structure of the Federal Reserve System is the result of compromise. Explain.

HISTORICAL NOTES

Introduction

Money and banking have been subjects of active public and political debate since the days of Colonial America. In fact, questions concerning the control of the quantity of money and the role of financial institutions have often dominated the political scene in the United States.

Throughout our history, the interplay of several political and economic events has raised some interesting questions. For example, did changes in the supply of money adequately meet the needs of a dynamic and growing economy? Did the mechanisms for controlling the supply of money produce the "right" amount, consistent with the goals of price stability, economic growth and reasonably full employment of resources?

Neither the videotape nor this Guide fully answers these questions. Rather, each attempts to shed some light on the role of money in our economic history and the creation by Congress in 1913 of the Federal Reserve System as the agency primarily responsible for maintaining the stability and health of our monetary and financial system.

The Colonies

The issue of what constitutes the "right" amount of money dates from the Colonial times. Because money is so essential to an economy's trade and commerce and to the living standard of its people, the thirteen Colonies (generally independent of each other) devised ways to supplement the rather limited amount of gold and silver coins (specie) in circulation. Much of the gold coin in circulation in the Colonies — called Spanish dollars or "pieces of eight" — originated with Colonial trade with the West Indies. While satisfying much of the Colonists' domestic needs of trade, these Spanish coins were also used to pay for imports from England and other nations.

Some Colonies resorted to the use of commodity money, or "country pay," where a Colony's principal commodity would often circulate as a medium of exchange. In the New England and Middle Atlantic Colonies, for example, wampum or sea shells were used; in the Southern Colonies, tobacco and rice; and throughout most of the Colonies, animal skins, powder and gun shot, and livestock were often used. Since the market value of commodity money was determined by demand and supply, its value as money chronically depreciated when there was an oversupply in the marketplace. In addition, commodity money lacked uniform quality, was prone to spoilage, and was often difficult to transport and costly to store — shortcomings which reduced its usefulness as a medium of exchange.

With gold and silver coins in short supply and commodity money an unreliable standard, a number of the Colonies turned to the issuance of paper money. This type of money consisted of bills of credit issued by some Colonial legislatures and bank notes issued by land banks. These banks, which bear a faint resemblance to commercial banks today, made loans in the form of bank notes secured by the value of borrowers' mortgaged land. Since these land banks did not accept deposits but only issued notes, they were called "banks of issue." It was not until the early nineteenth century that these banks began to create deposits, instead of issuing paper notes, in connection with their lending activities, making them the forerunners of

today's commercial banks. By 1790 there were only four banks in existence.

Often, when the amount of bank-issued paper notes increased at a rate faster than the needs of trade and commerce, their purchasing power fell dramatically. The resulting inflation in prices prompted the British Parliament in 1751 and 1764 to forbid the issue of paper money, an action which was one of several factors leading to the American Revolution. On the eve of the Revolution, approximately three-quarters of the money supply was in the form of paper currency of banks of issue; the rest consisted of gold and silver coins.

In 1776, the Colonies established the Continental Congress which had the powers to borrow and spend but *not* the power to tax. Financing the Revolution was accomplished principally by printing paper money called "Continentals." Additional wartime financing came from foreign loans, primarily from France and Holland, and from voluntary assessments on the several states which they met by also resorting to printing money. At the time, it was assumed that the war for independence would be short-lived and that the limited amount of Continentals would be retired by the states through local taxes. Both assumptions proved to be wrong, however.

The new government, as well as the several states, issued excessive amounts of paper money. This resulted in sharp inflation and thus a dramatic reduction in the purchasing power of paper money, giving rise to the expression "not worth a Continental." Further, wartime-induced shortages of certain commodities such as iron, salt and sugar aggravated the inflation. In fact, in 1779 a Continental with a face value of one dollar was only worth two cents. The currency depreciation was so great that barter and payment in kind flourished. Further, gold and silver specie (both regarded more valuable as commodities than as money) were driven from general circulation. In 1790 the Constitutional Congress authorized the redemption of the Continentals outstanding in exchange for government bonds of the newly formed Republic.

The First Bank

After the adoption of the Constitution in 1789, which gave the new federal government spending, borrowing *and* taxing powers, one of the first problems faced by the young nation was the creation of a national monetary and financial system. While Article 1, Section 8 of the Constitution expressly gave Congress the power to coin money, the states were prohibited by Article 1, Section 10 from minting coins or issuing paper money in any form. In fact, the Constitution prohibited the states from making anything but gold or silver coin a tender in the payment of debts.

The economic vitality of the new Republic depended on the flow of money. Much of this money had come from foreign sources, primarily from England, but it slowed in the years following the Revolution. The fledgling economy had to devise its own institutions: commercial banks to issue paper notes and to accept deposits; other financial institutions (resembling today's investment banks) to underwrite and sell the securities of business corporations which would need tremendous amounts of capital to finance railroad and canal construction; and stock exchanges to enable investors to trade the newly issued corporate securities.

Alexander Hamilton, the first Secretary of the Treasury, played a pivotal role in the development of the new monetary system. He penned the Coinage Act of 1792, which provided for equal monetary roles of gold and silver. That is, a bimetallic monetary standard was established to avoid a shortage of money which had plagued the Colonists. When the minting of coin began in 1794, the newly established Mint set a specie exchange rate of one troy ounce of gold for fifteen troy ounces of silver. By the end of the eighteenth century, the market price of silver began to fall; an ounce of gold exchanged for fifteen and three-quarter ounces of silver. Since gold was worth more in terms of silver in the market than at the Mint, the use of gold coin as money all but ceased. (See Gresham's Law, page 10.)

Silver coins also began to disappear from circulation as profiteers exported the coin to Latin America where it was worth more. With silver specie reserves diminishing, Congress halted any further coinage of silver dollars in 1806; silver dollars were not coined again until 1836. What few U.S. silver coins remained were retained by banks as reserves against their paper note issues. Consequently, there was increased use of foreign coins for trade and commerce and as bank reserves. Hamilton's anticipated dual monetary roles of gold and silver specie failed to materialize.

The difficulty of establishing and maintaining at the Mint an exchange parity of gold and silver which matched that in the open market was to be a

recurring problem throughout the nineteenth century. However, the operation of Gresham's Law provided fertile ground for political and economic debate. It pointed up the need for a reliable monetary system not subject to the day-by-day vagaries of the market nor to the caprice of political or private institutions to provide the "right" amount of money.

Hamilton precipitated a heated political debate by recommending the chartering of the (First) Bank of the United States. He indicated that "whatever enhances the quantity of circulating money adds to the ease with which every industrious member of the community may acquire that portion of it which he stands in need." Hamilton's ideological rival, Thomas Jefferson, argued not only that the Bank's establishment was unconstitutional — that the power to create a bank was not among those enumerated in the Constitution — but also that banking establishments were more dangerous than standing armies.

Hamilton prevailed and the Bank, chartered by an Act of Congress in 1791, was among the largest companies in the nation at the time. The Bank was privately owned; the federal government was a minority shareholder. Private subscriptions of the Bank's stock were made in specie and in the form of federal government bonds.

The Bank marks the first deliberate step taken by the federal government in addressing the problem of determining the "right" amount of money. However, while the Bank was not intended to perform the functions of a central bank—those functions were not to be undertaken until Congress created a true central bank (the Federal Reserve System) — it did exert a considerable influence over the economy.

The Bank, through its several branches, performed certain fiscal functions for the federal government such as holding the government's cash deposits (mainly state bank notes) and extending it temporary credit. It also printed a uniform national paper currency which, like the paper notes of state-chartered banks of issue, was redeemable on demand in gold or silver specie.

It is generally agreed that one of the Bank's greatest successes was in providing a stable and sound uniform paper currency. Still, charges that it represented an unconstitutional monopoly of the federal government continued to permeate political discussions, and Congress, by a margin of one vote, decided not to renew the Bank's charter in 1811.

When the Bank's charter expired, there were approximately 88 state-chartered banks. By 1815, more than 200 banks were in business. This proliferation was due partly to the demise of the First Bank, which had exerted a restraining influence on the number of banks and their issuance of paper notes. More importantly, the surge in the number of banks was related to the federal government's borrowing requirements in financing the War of 1812. Reluctant to raise taxes and unable to borrow sufficient funds, the federal government turned to banks, which bought government bonds with newly printed paper bank notes. Between 1811 and 1815, the volume of bank notes increased more rapidly than the volume of specie reserves thereby forcing banks to suspend specie payments. Confidence in banks and in their paper note issues waned, pushing the banking system to the brink of collapse.

The Second Bank

The end of the War of 1812 marked the opening of the Western frontier and the growth of agriculture and manufacturing — developments requiring a sound and flexible banking and financial system. In 1816 Congress responded by chartering the Second Bank of the United States. The Second Bank brought a feeling of confidence and, in early 1817, banks resumed specie redemption of their paper notes.

The Second Bank was similar to the First Bank, but on a much larger scale. It was also privately-owned with the federal government a minority shareholder. When the Second Bank collected payments due the federal government (made largely in the form of state bank notes), it only accepted notes issued by banks which stood ready to redeem them on demand for gold and silver. When the Second Bank presented notes for specie redemption to the banks of issue, it exerted a significant influence, if not control, over the amount of paper notes in circulation.

Like the First Bank, the Second Bank had its political enemies who charged that it was unconstitutional and would cause concentration of economic power. The Bank's constitutionality was upheld, however, in the landmark Supreme Court decision of *McCulloch v. Maryland* in 1819.

In 1832, President Andrew Jackson, who vetoed a bill to recharter the Second Bank, began placing the federal government's funds in several favored state-chartered, or "pet," banks. Four years later, the Second Bank's charter was allowed to expire.

The Antebellum Period

States continued to be the sole regulator of banks, bank note issues and bank chartering. Since a charter and the authority to issue bank notes were financially rewarding, bank organizers often used corrupt means to obtain the limited bank franchises from the state. In addition, with restricted entry and little competition, banks tended to engage in lending activities and paper note issuance which made the banking system prone to periods of instability.

These problems led to an era of "free banking" where entry into banking was open to any who satisfied certain minimum capital requirements. Rather than receiving charters from state legislatures, banks were chartered under general incorporation laws of the state and were authorized to issue paper currencies provided they were secured with state bonds. This collateral requirement assured that the states would have a ready market for their bond issues. In addition, banks were required to redeem on demand their paper note issues in gold or silver specie.

This era has been called the "wildcat" banking period and was supposedly characterized by widespread fraud and bank speculation, mismanagement and failures. It is now generally recognized that that was not an accurate description. In fact, what was learned during free banking at the state level served as a basis for the establishment of the national bank system at the federal level. By the eve of the Civil War, approximately half of the thirty-two states had some form of free banking.

The Civil War...

The Civil War prompted a number of important changes in the banking and monetary system. Uncertainty about the length of the War, its outcome and how it would be financed caused widespread suspension of specie redemption both by the banks and the federal government, except on the interest payments on government bonds.

In 1861 Congress began to issue United States notes, called Greenbacks, the first instance of the federal government issuing fiat money, i.e., paper currency not redeemable in either gold or silver. In 1879 Congress resumed the convertibility of paper currency into gold. At the time of issue, Greenbacks were made legal tender for all private and public debts except for payments of custom duties and interest on the government's debt, both of which were to be made in hard (specie) currency form.

In 1863, Congress passed the National Bank Act which established a national bank system designed to reduce the cost of financing the Civil War. National banks — chartered by the newly established Office of the Comptroller of the Currency —were authorized to issue a uniform paper currency (called national bank notes) collateralized by the war bonds of the federal government. The collateral requirement created a ready market for the government's securities. By linking the issue of national bank notes to the amount of government bonds, Congress sought to provide a political mechanism to prevent the over-issuance of paper currency.

In 1865 Congress amended the Act in an attempt to encourage more banks to become national banks by placing a ten percent tax on the bank notes issued by state banks. While many state-chartered banks became national banks to avoid the tax, others began to use a new form of money — demand deposits or checkbook money. To a large extent, the government's bank-note tax hastened the growth and widespread use of checkbook money. By 1870, more than half of the nation's money supply consisted of demand deposits.

...And After

After the Civil War, prices in the economy declined until the end of the nineteenth century. In this environment, the Greenback and Populist Parties were launched. Both parties sought to reverse a falling price level and relieve frequent periods of economic distress through an expansion of the specie and paper forms of money. The Greenback Party advocated increasing the money supply through an increase in the outstanding volume of Greenbacks, while the Populist Party sought to expand the money supply through an increased minting of silver coins.

While it was not successful in obtaining an increase in the supply of paper currency, the Greenback Party did block the government's attempts to retire Greenbacks. The Populists were successful in passing a compromise — the Sherman Silver Purchase Act of 1890 — which required the purchase and coinage of a specified amount of silver each year. In 1893, the silver purchase and coinage requirement was repealed. The threat to gold convertibility was reduced when William McKinley defeated the pro-silver William Jennings Bryan for President in 1896. The pro-silver movement continued to wane as increases in the production of gold led to a worldwide gold-based inflation of prices.

The fifty year period following the Civil War, characterized by relatively high but uneven rates of economic growth and periods of slump, saw important changes in our monetary and banking system. There was the formal adoption of the gold standard in 1900, linking the money supply (paper currency and bank deposits) to the quantity of gold; the substitution of bank deposits for paper currency as the principal medium of exchange; the development of the dual banking system of national- and state-chartered banks; and the creation of a central bank — the Federal Reserve System — as a formal body with powers to influence our nation's supply of money and credit.

The Federal Reserve System

The economic boom which started in the 1890s lasted until a recession in 1907 triggered a banking panic. City banks found their reserves sharply depleted as depositors withdrew money. Also, country banks which held their reserves as deposits in city banks made withdrawals to meet the demands of their depositors. Banks all over the country were forced to restrict withdrawals or suffer the consequences. The concentration of monetary reserves in city banks and the seasonal demands for credit in agricultural areas made the banking system susceptible to shocks which were often magnified throughout the economic and financial system.

In 1908 Congress created a National Monetary Commission to study the banking system and its problems and to recommend changes to enhance its stability. After several years of study and debate, Congress passed the Federal Reserve Act which was signed into law by President Woodrow Wilson on December 23, 1913.

Today, the Federal Reserve System reflects the compromises which led to its establishment: (1) the seven top decision-makers — the Board of Governors in Washington, D.C. — are appointed by the President, with the advice and consent of the Senate; (2) the Governors are appointed for a term of fourteen years, thereby insulating their decisions from day-to-day political pressures; (3) twelve regional Federal Reserve Banks perform the operations of the Federal Reserve System, thus assuring that local considerations play a part in the decision-making of the central bank; (4) the directors of the Reserve Banks reflect the agricultural, service, labor and consumer, commercial and industrial, and banking and financial sectors of the economy; and (5) the Federal Reserve is not dependent on the Congress for its funding; instead, the central bank derives the bulk of its operating revenues from the interest it earns on its holdings of U.S. government securities.

One of the principal tasks of the Federal Reserve is to conduct monetary policy. By providing more or fewer reserves through monetary policy actions, the Federal Reserve is able to affect the ability of banks to make loans and investments. Unlike the banking institutions in our earlier history, today's banks create deposits when they make loans to borrowers. It is the supply of bank deposits which constitutes approximately seventy-five percent of our nation's money supply. The balance is in the form of coin and paper currency.

The amount of loans made and the new checkbook deposit money created by the banking system have an effect on the spending and investing decisions of households and business in our economy. This, in turn, heavily influences the general level of prices, the structure of interest rates, the intensity with which we use available human and material resources, and the level of production of goods and services. As a result of the power of its monetary policy, the Federal Reserve remains the subject of public and private debate — a debate over money and banking that is more than 200 years old.

Gresham's Law — Maintaining a Bimetallic Monetary Standard*

Throughout the early part of our monetary history, between 1792 and 1862, the U.S. was on a bimetallic standard. Under bimetallism, the U.S. Mint coined both silver and gold. However, it was only for brief periods that both minted coins circulated simultaneously.

For the monetary standard to work properly with both metals circulating, the Mint established an exchange value or rate between gold and silver. For example, the exchange rate at the time of Hamilton's coinage program of 1792 was one ounce of gold for every 15 ounces of silver. This rate was identical to that determined in the market at that time by the forces of supply and demand for these metals.

Shortly after minting began, the market price of silver began to fall and by 1799, an ounce of gold had a market value of 15.75 ounces of silver. In other words, an ounce of gold commanded three-quarters more of an ounce of silver in the market that at the Mint. The resulting problem is explained by Gresham's Law: gold (the "dearer" metal) was hoarded while silver (the "cheaper" metal) was kept in circulation, and the bimetallic standard gave way to a single (silver) metal standard.

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*Named after Sir Thomas Gresham who served as head of the English Mint during the reign of Queen Elizabeth I.

BIBLIOGRAPHY OF FREE MATERIALS AVAILABLE FROM THE FEDERAL RESERVE SYSTEM

Coins and Currency, 1981

This booklet reviews American money from wampum to Federal Reserve notes.

Request from:

Federal Reserve Bank of New York
Public Information Department
33 Liberty Street
New York, New York 10045

"Decline and Fall of the Gold Standard," *Business Review*, January 1976

"Development of Capital Markets in the United States," *Business Review*, April 1976

"Evolution of Money and Banking in the United States," *Business Review*, December 1975

These articles give an historical perspective on each subject and its significance in the economic development of the U.S.

Request from:

Federal Reserve Bank of Dallas
Public Affairs Department
Station K
Dallas, Texas 75222

Glass Insulation, 1978

This booklet discusses how the Federal Reserve was created and the significance of its independence from political pressures.

Request from:

Federal Reserve Bank of Philadelphia
Public Information Department
P.O. Box 66
Philadelphia, Pennsylvania 19105

Historical Beginnings...The Federal Reserve, 1977

This booklet traces the history of the U.S. banking system, describing nineteenth century banking problems and the legislation that led to the creation of the Federal Reserve System.

"Tough Acts to Follow," *The Ledger*, Volume 10, No. 2, June 1984

This article discusses several important pieces of federal banking legislation between 1862 and 1982.

Request from:

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"Origins" and "The Aldrich Plan," *Weekly Letter*, December 30, 1983 and January 6, 1984

These articles discuss developments in U.S. history leading to the passage of the Federal Reserve Act in 1913.

"Beginnings" and "The Formative Years," *Weekly Letter*, October 26, 1984 and November 9, 1984

These articles discuss the structure of the Federal Reserve System from an historical point of view.

"The Structure of Our Nation's Central Bank," *Weekly Letter*, February 8, 1985

This article describes the Federal Reserve System today.

Request from:

Federal Reserve Bank of San Francisco
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P.O. Box 7702
San Francisco, California 94120

"Free Banking, Wildcat Banking and Shinplasters," *Quarterly Review*, Fall 1982

This article discusses the free banking era.

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